

THE EVOLVING LEGAL FRAMEWORK FOR FINANCIAL SERVICES

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This paper summarizes both the history of financial services regulation in the United States and the conflicting models of political economy, or the legal framework, that lay behind that history. The principal supervisory intervention and closure options available to financial services regulators by the late 1980s are described briefly. Many of those options were modified or even extended by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)¹ but numerous older supervisory tools that had fallen into disuse after the advent of federal deposit insurance and direct federal intervention in the capital markets affecting financial services institutions during the 1930s remain neglected.

The primary purpose of this paper is to review the legal framework for the supervision and regulation of financial services both as it has been and as it might be. Specific policy recommendations regarding expansion of the activities of one set of financial institutions across industrial sector lines into the domains of other financial institutions, or innovations in financial services supervision, are beyond the scope of this paper.

A Brief History of Financial Services Regulation in the United States

It is a common misconception that banks and trust companies, bank holding companies, thrift institutions, credit unions, securities firms,

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¹FDICIA, enacted December 19, 1991, is Public Law No. 102-242.

insurance companies, mutual funds, and the like, all of which are usually referred to as financial services companies, have existed in more or less their present form throughout U.S. history or, even earlier, in British history.² But the present common legal form of large banking organizations in the United States, a bank holding company with many banking and nonbanking subsidiary corporations, was rare in the 19th century and became the generally accepted model only after World War II. The most frequently advocated alternative model for large banks, a universal bank with branches nationwide, has never existed in the United States, and the closest approximations, the First and Second Banks of the United States, were so limited in their asset powers that they could not properly be called universal banks.³ Even in Great Britain, the model of the universal bank with nationwide branches has come into existence only since enactment of the Financial Services Act of 1986.⁴

Prior to enactment of the National Bank Act (1863), most American banks did not have corporate charters, and even those that did still exposed their shareholders to double liability. Shareholders were liable to the bank regulator for assessments up to the par value of their shares, then a substantial amount, if the bank's assets were insufficient to satisfy liability holders' claims. Thus, there was a fair amount of personal liability on the part of directors and ordinary shareholders if their institutions failed. Also, before the National Bank Act, most bank charters were issued only for limited terms—20 years was the most common.

Perpetually chartered, limited-liability, incorporated banks having as their principal liabilities deposit accounts instead of circulating notes were a novelty of the second half of the 19th century in the

²Other nations' histories either are or have been somewhat relevant to (and are often cited as possible models for) the restructuring of American legal and financial services institutions. Although those histories are interesting and often instructive, the hard fact remains that, as a matter of legal history, only the English and Scottish experiences are directly relevant to the actual evolution of the framework for the American financial services industry. The future, of course, might be different, but the past is less mutable on this point than proponents of universal banking or expanded governmental subsidies of the financial services industry might wish to acknowledge. For detailed analysis of this issue, see Mark Roe (1993).

³Useful summary descriptions of the legal structures of the First and Second Banks of the United States appear in Judge Harold Greene's supplemental opinion in *Melcher v. Federal Open Market Committee*, 644 F.Supp. 510 (District Court D.C. 1986). Subsequently, *Melcher* was affirmed on other grounds, 836 F.2d 561 (D.C. Cir. 1987); certiorari denied, 486 U.S. 1042 (1988).

⁴Good descriptions of the legal forms and structural organizations found among large banks in early American history appear in Bray Hammond (1957) and J.S. Gibbons (1859). A comparable description for Britain, especially for Scotland, is in Lawrence White (1984: 23-49).

United States. The National Bank Act authorized "national associations" to obtain federal banking licenses in order to enable partnership and sole-proprietorship banks to join the bond-secured currency scheme, and state law also licensed banks but did not require them to incorporate.

Neither the Federal Reserve Act (1913) nor the Banking Acts of 1933 and 1935 required member banks to incorporate, and the double liability of national banks' shareholders was not eliminated until the Banking Act of 1935. Instead, the impetus for incorporation was provided by the Emergency Banking Act of 1933, which authorized the Reconstruction Finance Corporation (RFC) to assist the reorganization of troubled banks by purchasing their preferred shares (it was easier to obtain the RFC's assistance for incorporated banks). Private banks holding commercial bank or trust company licenses still exist under New York state law: Brown Brothers Harriman is one example, and even J.P. Morgan & Co. did not incorporate until 1940 and did not become a widely held, publicly traded corporation until the 1950s.

Investment companies, securities broker-dealers, investment banks, mutual funds, mutual thrift institutions, mutual insurance companies, and the like are not required to incorporate as a matter of law. It is possible to derive from this description of the prior legal framework the hypothesis that it was the personal liability of the principals of unincorporated financial services institutions that used to encourage the prudent operation of their firms, and that it was governmental incentives like the prospect of RFC assistance that tempted those principals to incorporate (see analogous arguments in Edward Kane (1987: 104-05), and Adam Smith (1976, book II: 329-37).

More than just banks alone, financial services corporations were generally considered to create moral and legal difficulties that ordinary business corporations did not because, before the Free Banking Era (1838-61), they depended on the favor of the state for their corporate charters and continued profitability. Adam Smith wrote disparagingly of the joint-stock trading companies of his day; the framers of the Constitution noted the American prejudices against corporations of any type, but especially against "monied corporations," and deliberately failed to include an incorporations clause in the Constitution; Andrew Jackson opposed banks primarily because they promoted the circulation of paper money; late 19th and early 20th century political rhetoric denounced the "money trust"; New York attorney Charles Evans Hughes became famous as legislative counsel investigating the misdeeds of insurance companies in 1905; and as late as 1913-14, Louis Brandeis wrote a series of articles (later compiled into a book) on the economic inefficiencies of large holding companies of the

J.P. Morgan model, entitled *Other People's Money and How the Bankers Use It*.⁵ Both Hughes and Brandeis later became justices of the U.S. Supreme Court.

Abundant arguments existed on the other side, to be sure: Alexander Hamilton succeeded in obtaining a federal corporate charter for the First Bank of the United States; Chief Justice John Marshall sustained the constitutionality of the federal corporate charter of the Second Bank of the United States in *McCulloch v. Maryland* (4 Wheaton [17 U.S.] 316 [1819]); a whole system of federally chartered national banking associations was established under the National Bank Act; and incorporated Federal Reserve Banks were established nationwide under the Federal Reserve Act of 1913.⁶ Financial services companies could and did exist in corporate form and even with federal charters, but the older, Jeffersonian, Madisonian, and Jacksonian notions of minimal federal interference in state regulation of financial services have prevailed to the extent that the chartering, licensing, and most forms of supervision of nonbank financial firms remain the exclusive domain of state law.⁷

Reforms of the 1930s changed the legal framework for financial services significantly, but banks and, later, bank holding companies were more directly affected by federal centralization and regulation than were nonbank financial firms. For the most part, the latter were allowed to continue operating under state law, becoming subject only to federal registration and information disclosure laws in the 1930s and federal consumer protection legislation in the 1960s and 1970s. Federal deposit insurance was created in 1933 and was made available to state-chartered, nonmember banks as well as to Federal Reserve member banks, then considered a political triumph for proponents of state banking. A serious attempt was made to nationalize all bank supervision as part of the Emergency Banking Act of 1933 (Wyatt 1933), but that effort was abandoned in favor of the de facto nationalization of both financial and nonfinancial firms' capital structures between 1932 and 1947 under the Reconstruction Finance Corporation Act (see Todd 1992). Bank branching activities, which became restricted in the early 1900s, were liberalized in 1927 but retrenched somewhat in 1933, and branch banking did not expand significantly again until the 1960s. Bank holding company expansion became a

⁵See A. Smith (1976, book V, chapter 1: 245–82); Tansill (1965: 563, 724–25); Schlesinger (1945: 76–77); Mowry (1958: 79); and Brandeis (1914: 135–223).

⁶See Hamilton (1790, 1791); Hart (1899: 230–52, 274–88); and Smith and Beasley (1972: 90–94).

⁷See Jefferson (1791); Madison (1791); James (1938: 556–58); and Schlesinger (1945: 76–77).

device for evading restrictive branch banking laws in the 1920s, but was retrenched between the 1930s and the early postwar years. The Bank Holding Company Act of 1956, its 1966 and 1970 amendments, and the International Banking Act of 1978 (for foreign banks) imposed federal restrictions on bank holding company and foreign bank expansion that have made the creation of nationwide branch or subsidiary banking networks legally and practically impossible, although the advent of automated teller machines has tended to undermine these restrictions.

On the whole, prior to the 1980s, the legal framework for financial services regulation in the United States was constructed roughly as follows:

1. Banks and bank holding companies were regulated primarily at the federal level, but limited chartering and supervisory responsibilities were retained at the state level.

2. After the 1960s, a gradual trend emerged pursuant to which investment banks, securities broker-dealers, and mutual thrift institutions converted to corporate form. The securities firms retained their general independence from federal regulation other than the registration and disclosure type of requirements.

3. Since the 1970s, it has generally been presumed in banking reform circles that financial services companies should be allowed to engage in all activities not specifically prohibited. Efforts to have federal bank regulators expand the range of permissible activities by administrative interpretation have tended to reflect that presumption. But the long-standing prior view under American and British law was that only activities specifically authorized or "so closely related to banking or managing or controlling banks as to be a proper incident thereto" should be permitted for member banks and bank holding companies.⁸ In other words, the governing assumptions regarding the appropriate boundaries of the legal framework for financial services have changed within the last 20 years or so, but the reasons for that change remain somewhat unclear. In any case, the implementation of the altered assumptions through administrative decisions has had uneven success in the courts.⁹

⁸This phraseology appears in Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. Section 1843).

⁹See, for example, *Board of Governors v. Dimension Financial Corporation*, 474 U.S. 361 (1986), in which the Supreme Court decided, 8-0, that the Board lacked the authority to reinterpret the statutory definitions of terms like "bank" or "commercial loan" in Section 2(c) of the Bank Holding Company Act (12 U.S.C. Section 1841) so as to extend the Board's regulatory authority to nonbank banks. Such banks generally remain outside Federal Reserve regulation unless they are owned or controlled by banks or bank holding companies. On

4. Some authorities maintain that there is a type of “natural market segmentation” or compartmentalization in the financial services industry, to which a legal structure eventually returns, with commercial banks specializing in short-term loans to fund industrial, agricultural, and retail enterprises; thrift institutions specializing in home mortgage finance; insurance companies sticking closely to core insurance and annuity activities; and securities firms and investment banks financing the medium- and longer-term credit requirements of commercial and industrial enterprises. Such segmented or compartmentalized systems have appeared, in fact, in America periodically from the time of Alexander Hamilton to the present moment, but most modern proponents of banking reform in academic circles have advocated reduction or elimination of geographic and activities restrictions on financial services companies.¹⁰ Intra-industry and intra-regional consolidation tends to reduce the competition that is presumed in a free market, but the modern proponents of banking reform apparently prefer to have different industry sectors compete against each other to restore competitive balance. It is unclear how well grounded in historical analysis the current reform proposals are, but advocates of sectoral segmentation and compartmentalization usually base their arguments on historical analyses that, of course, the opponents contest.¹¹

Conflicting Models of Political Economy

Before drawing hard and fast conclusions about the appropriateness of different approaches to financial services reform, it is useful to review the principal attributes of the competing models of political economy that might be relevant. In the United States, socialist models have been disfavored, but strong centrally planned models like corporatism occasionally have been accepted in governing circles, during the First New Deal, for example (Phillips 1992). Classical liberal or negative liberty models have as their principal attributes preferences

the other hand, most of the Board's orders liberalizing securities powers of the affiliates of member banks, reversing prior, limited interpretations of Section 20 of the Banking Act of 1933 (12 U.S.C. Section 377), have withstood court challenges since the early 1980s.

¹⁰The idea of “natural market segmentation” is discussed favorably by, among others, John Austin Stevens (1898: 264), and, nearly 100 years later, Hyman Minsky (1993), who in turn credits Jan Kregel (1992) for this idea. On the other hand, the idea of dismantling segmented or compartmentalized financial services institutions is discussed favorably by, among others, Catherine England (1993), George Kaufman (1993), and U.S. Treasury (1991).

¹¹The best-known historical analyses in favor of segmentation and compartmentalization of financial services are Louis Brandeis (1914) and Ferdinand Pecora (1939). Among the better-known recent critiques of those analyses are Eugene White (1986) and George Benston (1990). For a good current restatement of the recent critiques, see David Wheelock (1993).

for the operation of free markets under the Rule of Law (see Hayek 1944). Such free markets are usually characterized by the absence of protectionism (no artificial barriers to market entry) and the absence of subsidy, which might be negative (as with supervisory forbearance, for example; see Woodward 1992). But utilitarian or positive liberty models, with attributes preferring limited governmental intervention or regulation in the operations of markets to correct for perceived “market failures,” have adherents whose views might be described as the dominant world view in Washington since the 1930s. One way of explaining the 1930s’ financial services reforms is as the product of a struggle between Brandeis antitrust liberals (utilitarians) and central planners of the left corporatist type, e.g., Rexford G. Tugwell and, perhaps, Adolf A. Berle (see Phillips 1992: 62–67; and Olson 1988: 111–14).

In general, it was the classical liberals who lost out in those 1930s’ policy debates.¹² Thus, classical liberals need to think carefully before defending 1930s’ policy reforms. Similarly, those whose reference points are earlier, the era of Alexander Hamilton and Thomas Jefferson, for example, should bear in mind comparable distinctions as to appropriate models. Hamilton was essentially a positive liberty thinker, while Jefferson’s and, to a slightly lesser degree, Madison’s ideas reflect negative liberty values. Utilitarian and corporatist methods often are inconsistent with classical liberal models—a principle that should be remembered as we evaluate the supervisory and regulatory structures described below.

Regulatory Intervention and Closure Options in the 1980s

Banks, bank holding companies, and thrift institutions were subject to the supervisory and regulatory intervention and closure procedures described below during the 1980s. Some of these procedures evolved from specific supervisory experiences during the 1960s and 1970s, such as limitations on standby letters of credit (1974), but most were derived from statutory changes in the 1930s or even from long-standing banking customs. Not until enactment of the Competitive Equality Banking Act of 1987 (CEBA) for the thrift industry and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) for federally insured institutions generally was there a statutory shift away from the long-term trend toward relaxation of

¹²Herbert Hoover and Carter Glass were, I suppose, the leading illustrations of this proposition. See generally Hoover (1952) and Rixey Smith and Norman Beasley (1972).

examination and capital ratio standards, the low point of which was the Garn–St Germain Act of 1982. Garn–St Germain was perceived as having created perverse incentives for insured institutions, and CEBA and FIRREA generally were viewed as attempts to rein in some of the excesses attributed to those incentives (see generally Kane 1989, and Mayer 1992). Basically, FIRREA was an attempt to reintegrate the legal and economic rationales for supervisory intervention, and FDICIA has carried that attempt somewhat further.

Most of the enforcement tools needed by supervisors and regulators already existed before FDICIA was enacted in 1991. The federal bank supervisory and regulatory agencies' powers to intervene in the affairs of banks and bank holding companies ordinarily were limited to such institutions in troubled or failing condition prior to enactment of FDICIA. Apart from filing periodic call reports or submitting to supervisory examinations or inspections, most banks and bank holding companies had, and after FDICIA still have, uncontentious relationships with their supervisors and regulators. Most banks are not required to restructure their liabilities in ways that affect the legal rights or financial returns of depositors and other claimants. This part of the paper ignores issues regarding the supervision and regulation of institutions that would be classified as adequately or well capitalized under FDICIA's standards and focuses instead on the supervisory regime for troubled and failing institutions before FDICIA. The next part of the paper focuses on changes to that regime made by FDICIA.

Enforcement Actions

The three principal federal bank supervisory and regulatory agencies (hereafter referred to simply as the Agencies) long have had at their disposal a variety of instruments to redirect a bank's affairs. Possibly the most significant is the cease-and-desist order.¹³ Section 8(b) of the FDI Act authorizes the Agencies to issue such orders against insured banks and institution-affiliated parties. Before initiating the action, however, an Agency must find that an unsafe or unsound practice has occurred, is occurring, or is about to occur, or that a violation of law, regulation, written agreement, or other written condition imposed by the Agency has occurred, is occurring, or is about to occur. After making the required findings, an Agency must satisfy

¹³Other similar enforcement actions employed by the Agencies are the written agreement and the memorandum of understanding. Like the cease-and-desist order, the written agreement is a formal supervisory action. The memorandum of understanding, however, is informal. The Agencies, with respect to commercial banks, are the Federal Reserve, the Office of the Comptroller of the Currency, and the FDIC.

several procedural requirements, including giving notice to the named parties and providing the opportunity for a hearing, before it may issue an order. Once such an order becomes final, it is enforceable by the courts (see 12 U.S.C. Section 1818[i][1]). Violations of a cease-and-desist order may also result in the imposition of civil money penalties by the Agencies, which may reach \$1 million per day (12 U.S.C. Section 1818[i][2]).

Cease-and-desist orders are flexible, multipurpose tools for requiring the affected party to take or to stop certain actions or to take certain actions only after Agency review and approval. They have been used by the Agencies to address a wide variety of banking problems, ranging from unsound loan administration to weak management and violations of law. Typical orders might restrict the payment of dividends, require improved capital ratios, or mandate the development of programs to improve earnings. Since 1989, the Agencies have been explicitly authorized to require the affected parties to take affirmative action to correct conditions resulting from the violation of law or from the unsafe or unsound practice that caused the order to be issued.¹⁴

Removal of Deposit Insurance

The FDIC may terminate a bank's federal deposit insurance pursuant to Section 8(a) of the FDI Act (12 U.S.C. Section 1818[a]). The statute generally provides that the FDIC may initiate a proceeding once it determines that there exist violations of law or unsafe or unsound practices that require the termination of insurance. Insurance also may be terminated if the FDIC determines that the institution is in such an unsafe and unsound condition that it may not continue operations as an insured bank. Once a final order terminating insurance becomes effective, following notice, hearing, and appeal, the insured deposits of the bank remain insured, less withdrawals, for a period of at least six months or for as long as two years, as the FDIC might decide. Additions to existing deposits and new deposits after final termination are not insured. In similar circumstances under Section 8(a), the FDIC may suspend deposit insurance if it has reason to believe that the insured bank has no tangible capital left under the capital guidelines or regulations of the appropriate Agency.

¹⁴12 U.S.C. Section 1818(b)(6). This section specifically lists the following types of affirmative action that affected institutions may be required to take: 1) restitution for certain losses; 2) restrictions on asset growth; 3) disposal of any loan or other asset; 4) rescission of agreements or contracts; and 5) employment of qualified officers and employees who may be subject to approval by the Agency. It should be self-evident that not all onerous banking regulations proceeded from FDICIA alone.

Forfeiture of Bank Charter

The Office of the Comptroller of the Currency (OCC) may initiate suit in federal court to determine whether directors of a national bank have knowingly violated the National Bank Act or the Federal Reserve Act. Upon judgment of such violation, the rights, privileges, and franchises of the bank are forfeited.¹⁵ In such circumstances, the bank probably would be liquidated, or a bridge bank might be created.

Conservatorship

Prior to FDICIA, the OCC could, without notice or a prior hearing, appoint a guardian or caretaker for a national bank, called a "conservator," whenever the Comptroller determined that one or more of ten conditions listed in 12 U.S.C. Section 203(a) and (c) existed with respect to that bank. The conditions listed that were most directly relevant to this paper included:

1. The bank is in an unsafe and unsound condition to transact business, including having substantially insufficient capital or otherwise, and

2. The bank has incurred or is likely to incur losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the bank's capital to be replenished without federal assistance.¹⁶ Even when the listed conditions were satisfied, the language of the National Bank Act made it clear that the appointment of a conservator by the OCC is discretionary.

The OCC's objectives in appointing a conservator, who may be the FDIC, are to take possession of the bank and to take such actions as might be necessary to conserve its assets pending disposition of its business. The conservator acts with all the powers of the bank's shareholders, officers, and directors, and unless the OCC prohibits his

¹⁵12 U.S.C. Sections 93(a) and 501(a). Directors of national banks may be personally liable for damages caused to the banks or to others because of their consensual violations of the National Bank Act or the Federal Reserve Act.

¹⁶12 U.S.C. Section 203 was completely rewritten by FIRREA in 1989. The general counsel of the Federal Reserve Board, Walter Wyatt, drafted the original Bank Conservation Act (12 U.S.C. Sections 201-211) as Title II of the Emergency Banking Act of March 9, 1933 *Federal Reserve Bulletin* (19)(3): 115; see also Jesse Jones (1951: 21-22). The former condition for appointment of a conservator under Wyatt's version of Section 203 was "whenever [the OCC] shall deem it necessary in order to conserve the assets of any bank for the benefit of the depositors and other creditors thereof." In other words, no explicit finding of actual or potential insolvency was required, but former Section 203 provided explicitly that a conservator was to have all the powers of a receiver, in addition to powers necessary to operate the bank. Jones (1951: 22) notes that the title "conservator" was "akin to receiver but less harsh on the public ear." The original object of conservatorship "was to stave off creditors long enough to rehabilitate a bank rather than let it go into receivership."

doing so, he may continue to operate the bank as the same legal entity.¹⁷ The conservator may receive new deposits and use them to satisfy the claims of previously existing depositors, which does not necessarily matter much if the grounds for his appointment do not include the bank's actual or prospective insolvency. However, the capacity to use new deposits to pay off old deposits is an important (albeit economically unsustainable) power if the bank actually is or is likely to become insolvent. The bank may challenge the appointment of a conservator within 20 days (12 U.S.C. Section 203[b][1]), but conservatorship usually continues until the OCC (together with the FDIC, if it has been appointed as conservator) decides that the conservatorship may be ended safely and the bank either is permitted to resume business or is sold, merged, or liquidated (that is, a receiver is appointed), etc.¹⁸

Receivership

Before FDICIA, the OCC could appoint a receiver for a national bank whenever "after due examination of its affairs," he found that (a) the bank had forfeited its charter for knowing violations of the National Bank Act;¹⁹ (b) a creditor had obtained a judgment against the bank that remained unpaid for at least 30 days; or (c) the bank had become insolvent (12 U.S.C. Section 191). An additional ground for appointment of a national bank receiver before 1934 was failure to redeem circulating national bank notes—in fact, it was on this ground that most court cases involving national bank insolvencies were decided before 1934, when circulating notes were terminated.²⁰

¹⁷12 U.S.C. Section 206, as amended in 1989 by FIRREA. Previously, Section 203 provided that a conservator had all the rights and powers of a receiver and that the rights of all parties with respect to a conservator were "the same as if a receiver had been appointed," which limited the conservator's capacity to maintain uninterrupted banking services (for example, claimants against conservatorships could not have obtained full satisfaction of their claims—to the possible prejudice of other claimants—without judicial approval). Now, a judicial order might be necessary to *prevent* the conservator from satisfying some claims in full, to the potential detriment of other claimants.

¹⁸12 U.S.C. Section 205. Former Section 205 provided for termination (other than by "reorganization" under Section 207 [repealed in 1989] or conversion into receivership) whenever the OCC decided that it could safely be done and would be in the public interest.

¹⁹The knowing violations of the National Bank Act prohibited under 12 U.S.C. Section 93 were not amended by Title IX of FIRREA, which established civil money penalties for violations of the Act. Those knowing violations include the acceptance of deposits after the commission of an act of insolvency, or in contemplation of such an act (12 U.S.C. Section 91). This prohibition against the acceptance of new deposits while knowingly insolvent was enforced frequently until 1934 (when federal deposit insurance commenced), but has been enforced only rarely since then and not, to the author's knowledge, within the last 20 years.

²⁰See 12 U.S.C. Section 192 and cases cited thereunder. Many lawyers are deceived by looking only under Section 191 for cases involving insolvent national banks.

Since 1933, the insolvency of a national bank has generally been determined by a "maturing obligations" test—that is, capacity to meet maturing obligations, rather than a mere excess of liabilities over assets. However, before 1933, occasionally since 1933, and again after FDICIA, insolvency has also been determined by what amounted to a balance-sheet test (an excess of liabilities other than capital over assets, at book value). That is, a national bank might dishonor maturing obligations or its own circulating notes (pre-1934), or close its doors (which often happened during panics; when circulating notes could not be redeemed in specie), but the final regulatory determination of insolvency, reflecting the condition of the bank's balance sheet, among other factors, would be made by the Comptroller. [See *Smith v. Witherow*, 102 F.2d 638 (3d Cir. 1939).]

It is worth noting that the balance-sheet test for insolvency could rely fairly safely on book-value accounting in the past (pre-1933) because national banks then held no long-term assets whose market value would have differed significantly from book value, or historic cost. Also, cash-accounting principles were commonly used for banks prior to 1933, which meant that divergences in asset values due to the lags of accrual accounting usually did not exist. The general transition to historic cost accounting principles for banks occurred pursuant to a supervisory agreement in 1938 (see Mengle 1991, and Simonson and Hempel 1992).

Whichever test is applied for the appointment of a national bank receiver under 12 U.S.C. Section 191, the OCC's decision is entirely discretionary and cannot be compelled by the bank's creditors, although it may be attacked by the bank itself. Once appointed, the receiver (usually the FDIC for insured banks) ordinarily has no mandate other than to take control of the bank's assets and affairs, wind up its business, and close the bank (12 U.S.C. Sections 191 and 194). After all creditors have been paid in full, the OCC (or the FDIC, if acting as receiver) must call a shareholders' meeting to determine whether the receiver, or an agent elected by the shareholders, should complete the distribution of receivership assets to shareholders or should further manage affairs (12 U.S.C. Section 197).

Bridge Banks

Bridge banks share many common attributes with and serve many of the same economic objectives as national bank conservatorships. The principal difference is that bridge banks are organized and administered by the FDIC, while the OCC appoints national bank conservators. In effect, the bridge bank power enables the FDIC to take over failing banks even though the FDIC is not a charter-issuing agency.

Bridge banks were authorized under Section 503 of CEBA (1987)(now 12 U.S.C. Section 1821 [n]). Previously, in states without conservatorship statutes, there was no orderly way for the FDIC to encourage state regulators to close state-chartered banks while assuring those regulators that the banking operations of the closed banks would continue—occasionally an important factor in establishing political support for the closure. The CEBA provisions regarding bridge banks required actual closing of an insured bank before a bridge bank could be chartered to continue its operations (former 12 U.S.C. Section 1821[i][1]).

FIRREA (1989) amended the bridge bank provisions of the FDI Act to authorize the chartering of a bridge bank whenever it is determined by a court, the appropriate administrative body, or the appropriate Agency that one or more insured depository institutions are either “in default” (that is, a conservator, receiver, or other legal custodian is actually appointed) or “in danger of default” (that is, it is determined either that the insured institution cannot meet maturing demands or obligations without federal assistance or that the insured institution has incurred or is likely to incur losses that would substantially deplete all of its capital without federal assistance).²¹ Thus, the creation of a bridge bank no longer need await a chartering authority’s formal closing order and becomes largely discretionary on the part of the FDIC.

After the FDIC’s board of directors authorizes the organization of a bridge bank, the OCC *must* charter it (12 U.S.C. Section 1821 [n][1][A]). A bridge bank is deemed a new, insured national bank from the time it is chartered, “in default” for the purpose of abridging certain contractual obligations of the former depository institution, operating without capital, and *not* an agency, establishment, or instrumentality of the U.S. government.²² In order to organize a bridge bank, the FDIC’s directors must determine that at least one of the following conditions exists:

1. The costs of operating the bridge bank would not exceed the costs to the FDIC of liquidation;
2. The continued operation of an insured bank is essential to provide adequate banking services in the community; or
3. The continued operation of the former bank is in the best interest of its depositors (12 U.S.C. Section 1821 [n][2][A]).

²¹FIRREA Sections 204 and 214; 12 U.S.C. Sections 1813(x) and 1821(n). These criteria are essentially the same as those for appointment of a receiver or conservator of a national bank, except for the new balance-sheet test and having fewer than five directors, added by FDICIA.

²²12 U.S.C. Section 1821(n)(1)(E), (n)(2)(A)–(C), and (n)(5)(A).

A bridge bank may assume only the deposits and other liabilities and purchase only the assets of the defaulting insured bank that the FDIC determines to be appropriate.²³ A bridge bank generally can exercise all the corporate powers of a national bank, without having to observe national banks' capital adequacy requirements. Its existence is limited to two years, but this may be extended by the FDIC for up to three additional one-year periods (12 U.S.C. Section 1821 [n][4] and [9]). The statute anticipates that any bridge bank will be merged, sold, or otherwise disposed of during its existence (12 U.S.C. Section 1821 [n][10]-[11]). If not, the FDIC is to dissolve it and commence liquidation, with the OCC appointing the FDIC as receiver (12 U.S.C. Section 1821 [n][12]). Hortative language in the statute (12 U.S.C. Section 1821 [n][3][B]) apparently contemplates that existing borrowers and depositors continue to be accommodated.

Changes Effected by FDICIA

FDICIA changed the supervisory intervention and closure regimes described above only minimally, but added a new set of intervention powers: capital-based prompt corrective action (Sections 131-133 of FDICIA), designed to impose a supervisory duty to avoid or minimize loss to the deposit insurance funds and, ultimately, to the taxpayer. Under prompt corrective action, there is essentially an increasing degree of supervisory intervention in an insured institution's affairs as the leverage capital ratio (capital vs. total assets) or the risk-based capital ratio (capital vs. risk-adjusted or weighted assets) declines.

Five capital ranges are established for open depository institutions, ranging from well-capitalized to critically undercapitalized. The Agencies are authorized to define the capital adequacy ratios for those ranges. Only the first two ranges (well-capitalized and adequately capitalized) may be exempted from prompt corrective action as capital adequacy declines. Once capital reaches the critically undercapitalized level, currently defined as a Tier 1 leverage capital ratio of 2 percent or less, the institution must be closed within 90 days, unless the Agency grants an extension that can be renewed only once (conservatorships and bridge banks are exempted from this rule). While Agency discretion played an important role in the pre-FDICIA supervisory regimes, that discretion has been severely limited by the prompt corrective action provisions in order to mandate the abandonment of supervisory forbearance by the Agencies. Rightly or wrongly, Congress

²³12 U.S.C. Section 1821(n)(1)(B) and (n)(3)(A). Thus, the FDIC has virtually complete discretion to determine the composition of the liabilities and assets of a bridge bank.

believed that it was forbearance that either caused or increased the losses incurred by the Resolution Trust Corporation and the Bank Insurance Fund during the 1980s.²⁴

Other relevant changes made by FDICIA include:

Enforcement Actions. The criteria for issuance of cease-and-desist orders were amended by adding the receipt in an institution's most recent report of examination of a less-than-satisfactory rating for asset quality, management, earnings, or liquidity. If the deficiency goes uncorrected, the appropriate Agency may deem the continuance of the deficiency an unsafe or unsound banking practice (12 U.S.C. Section 1818 [b][8]).

Conservatorship. The standards for appointment of conservators of national banks were unified with those for appointment of the FDIC as conservator of insured state-chartered depository institutions (12 U.S.C. Section 1821 [c][5], effective December 19, 1992). The principal new feature of these revised standards is the explicit authorization of a balance-sheet test (an excess of liabilities over assets) as grounds for appointment of a conservator, as distinguished from the mere inability to satisfy claims as they mature.

Receivership. The receivership section of the National Bank Act (12 U.S.C. Section 191) was modified, effective December 19, 1992, to provide for the appointment of the FDIC as receiver of national banks *without prior notice or hearings* on the same unified grounds as for the appointment of the FDIC as conservator, including the explicit authorization of a balance-sheet test. Also, a receiver or conservator may be appointed if a national bank has fewer than five directors. No prior examination is required for the OCC to be authorized to appoint a receiver.

FDICIA made no other substantive changes in the bank supervisory intervention and closure regime. Of all these changes, it is reasonable to predict that the capital-based intervention standards and the procedures for prompt corrective action will prove to be the most far-reaching. FDICIA also contains language aimed at encouraging studies of market-value accounting and limiting the use of the Federal Reserve Banks' discount windows, but the risk-adjusted FDIC assessments probably will prove to be the most significant supervisory change other than the supervisory interventions foreseen under prompt corrective action. In general, it is fair to characterize FDICIA as a market-

²⁴Most of the relevant statutory amendments made by FDICIA are in the FDI Act. See generally Richard Carnell (1992) on prompt corrective action under FDICIA and on other legal issues related to FDICIA. On the costs of forbearance, see Thomas Woodward (1992) and James Thomson (1993).

oriented attempt to realign the legal and economic incentives underlying supervisors' and bankers' behavior in the same taxpayer-cost-reducing direction and away from forbearance.²⁵

After FDICIA: The Evolving Legal Agenda

The enactment of FDICIA essentially reflected congressional frustration and disappointment regarding the performance of depository institutions' supervisors and regulators over the prior decade. Only the national credit union industry, among depository institutions, has managed to avoid (thus far) the same degree of congressional scrutiny and mandate for supervisory intervention. However, it is reasonable to expect that the emergence of problems in that industry, albeit unlikely, also would give rise to FDICIA-like legislation.

Insurance companies remain almost entirely regulated by the states, but it is conceivable that high-profile failures of large insurers would generate enough political pressure to cause Congress to attempt to mandate uniform nationwide supervision. Under existing economic conditions, however, very few, if any, large insurance companies are likely to fail. In early 1993, press reports indicated that Representative Joseph Kennedy 2d (D.-Mass.) had introduced a bill to require insurance companies to comply with federal standards analogous to those for banks regarding disclosure of data on racial and demographic characteristics of customers, an anti-redlining measure. It appeared that the Kennedy bill contemplated offering increased access to the Federal Reserve Banks' discount windows in exchange for compliance with federal anti-redlining standards (Garsson 1993).

Securities firms and investment banks also continue to be chartered under state, not federal, law. Federal supervision of the securities industry, however, has been a fact of life since 1933, though state supervision continues to play an important role with respect to small companies, securities issues not registered with the Securities and Exchange Commission, and the like. It is conceivable that a few high-profile failures in the securities industry might trigger a congressional movement toward uniform, federal supervision. Mutual funds essentially are subject to the same kinds of supervision and chartering authority as securities firms and investment banks, but they currently experience a fairly high degree of federal supervision.

Comparatively few new powers are likely to be granted to federally insured depository institutions, given the prevailing mood in Congress. Interstate branching opportunities might arrive soon for well-capitalized

²⁵See Thomson (1993), Woodward (1992), and Carnell (1992).

banks, but increased insurance underwriting powers seem unlikely. It is fair to state that, currently, there is some support in Congress for regulatory relaxation tied to relief of the "credit crunch," but little support for wholesale expansion of banks into new business lines.

The rising importance of mutual funds seems to make them outstanding candidates for the next round of increased federal regulation of financial services companies. In my opinion, such increased regulation is unnecessary and would be unwise because of the implicit guarantee that federal supervision and regulation might carry for mutual fund activities.

For the 103rd Congress, at least, it appears that the principal legal agenda items regarding financial services are reform and restructuring proposals covering the federal bank supervisory authorities. Regarding the Federal Reserve, bills introduced in both houses of Congress during January 1993 would tend to centralize control in Washington of monetary policy deliberations that have been left until now in the hands of Reserve Bank presidents, whose selection is largely determined by directors elected by private-sector member banks.²⁶

In the House of Representatives, two bills would restructure the supervisory functions of the Agencies. Under the Gonzalez plan, a new Federal Banking Commission would be created as an independent regulator, and all supervisory responsibilities of the Agencies (except the National Credit Union Administration, or NCUA) would be transferred to it.²⁷ Under the Leach plan, a new Federal Banking Agency would be created as an independent regulator, with the OCC and the Office of Thrift Supervision combined into it. The new Agency would acquire jurisdiction over bank holding companies with federally insured subsidiaries whose assets are less than \$25 billion and whose principal subsidiary is a federally chartered depository institution, together with all stand-alone federally chartered banks and thrift institutions. The FDIC would be the federal supervisor for stand-alone state-chartered banks and thrifts as well as for bank and savings and loan holding companies with assets less than \$25 billion and whose principal subsidiary is a state-chartered institution. The NCUA's jurisdiction would remain unaffected. Thus, the Federal Reserve would be left as the principal supervisor of bank holding companies

²⁶See, for example, in the Senate, S. 212, introduced by Senator Dorgan (D.-N. Dak.), and S. 219, introduced by Senators Sarbanes (D.-Md.), Sasser (D.-Tenn.), Riegle (D.-Mich.), and Dorgan, both on January 26, 1993. In the House of Representatives, see H.R. 28, introduced by Representative Gonzalez (D.-Tex.) on January 5, 1993, and H.R. 586 and 587, introduced by Representatives Hamilton (D.-Ind.) and Obey (D.-Wis.) on January 26, 1993.

²⁷See H.R. 1214, introduced by Representative Gonzalez (D.-Tex.) on March 4, 1993.

with insured banks as their principal depository institution subsidiaries and with total assets in excess of \$25 billion. The Federal Reserve's supervisory jurisdiction would extend to all such bank holding companies' subsidiaries, regardless of the type of charter held. The Fed would also be the principal supervisor for all foreign banking activities and for U.S. activities of foreign banks with worldwide assets in excess of \$25 billion.²⁸

Whatever further legal reforms are attempted, it might prove useful when analyzing them to bear in mind the principles articulated above regarding competing models of political economy. For example, if we intend to achieve classically liberal results (market-determined outcomes) consistent with a least-government model, it might make more sense to leave the regulation and subsidy of insurance companies at the state, not the federal, level. In matters affecting the expansion of banks' powers, it might prove helpful to consider whether German universal banking models, for example, have anything useful to communicate to U.S. policymakers if the policymakers really intend to follow a classical liberal model of banking structure and regulation in the long run. It just might be the case that German-style universal banking works as it does because of a radically different set of accumulated customs, laws, and assumptions about the optimal method for organizing society than the set that has applied in the United States.²⁹ After all, one of Hayek's points in *The Fatal Conceit* (1988) is that the evolution of the structure of markets and institutions in capitalist societies is not independent of the societies' moral and ethical codes. If that proposition is true, then it ought to be necessary to change the German universal banking model to fit U.S. society, or to change U.S. society toward Germanic norms, if we set about to accommodate German-style universal banking.³⁰

If the optimal structure for the central bank or for the Agencies (federal bank supervisors) becomes the principal agenda item after FDICIA, it would be useful to apply the same principles described above to the analysis. An increased tendency to centralize monetary

²⁸See H.R. 1227, introduced by Representative Leach (R.-Iowa) on March 4, 1993.

²⁹Minsky (1993), citing Kregel (1992), observes that "the supervision of the German banks [which is located outside the Deutsche Bundesbank, the central bank] is much closer than anything contemplated in the States." Universal banking performs as it does in Germany, I argue, principally because of a greater and more long-standing tolerance for corporatist ideas in German society and under German law than has been the case in the United States. Many important German financial and industrial combinations would not have been allowed under U.S. antitrust laws and doctrines that have prevailed here for the greater part of a century.

³⁰An important new article on this topic is Roe (1993).

policy or supervisory powers in Washington might be consistent with centrally planned political economy models and with some varieties of utilitarianism, even though at first glance this would seem to be repugnant to classically liberal or mildly utilitarian principles. It is unclear that a rhetoric of free markets and free trade could be easily reconciled with the practice of strongly utilitarian or central planning methods in any logically rigorous way (see Neier 1993).

Conclusion

The legal and theoretical history of financial institution structure in the United States carries an ambiguous message for present-day policymakers trying to devise an optimal framework for financial services. At the inception, the dominant political economy model was classically liberal, but strong policymakers like Alexander Hamilton and, later, Nicholas Biddle strove constantly and with increasing success to introduce utilitarian attributes into that framework. A central bank was created, barriers to perpetual corporate charters for financial institutions became eroded, double liability for shareholders was dropped, federal deposit insurance was introduced, and what appears to be an inexorable tendency toward centralization of supervision in Washington has developed.

The recent policy debate has been dominated by questions regarding supervisors' powers to intervene, while the better question might have been whether it would be possible to return to a structure that reduced the role of federal supervisors and left a greater role for the states and for market discipline of financial institutions. If our methods and methodologies increasingly become strongly utilitarian or mildly corporatist, it is fair to ask whether it is logically correct or morally responsible to continue to use free-market (classical liberal) rhetoric to describe what we do. I would prefer to dismantle the structures that ensure increasing levels of centralization of the financial services supervisory framework and to return to the original, classical liberal model. Dismantling federal deposit insurance, separating solvency-support (capital-replacement) lending from the central bank and placing it on-budget at the Treasury, and restoring increased levels of manager and shareholder accountability for the conduct of their financial institutions would seem to be useful places to begin this process.

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FINANCIAL REFORM AND THE ENFORCEMENT PROBLEM

Gillian Garcia

The title of Walker Todd's paper, "The Evolving Legal Framework for Financial Services," gives the writer ample leeway to cover a wide range of related topics. A book on this subject, for example, might reflect on: the historical evolution of the current financial system; the different political philosophies current at the time the system was set up and later reformed; the political structure and its modus operandi, whether the financial system is centralized or "dual" as in the United States; the extent to which the contemporary financial structure efficiently and equitably meets the economy's structure and needs, both domestic and international.

The discussion would cover banks and other financial firms and would examine the customs, laws, and regulations that govern their operations. In addition, it would examine the enforcement of these laws. It would investigate the ability of the financial structure to take advantage of technological progress. In determining the extent to which the financial system is divided into separate compartments, it would comment on the degree of competition within and among the different segments. That examination would inevitably involve discussion of the powers that different segments possess, whether banks are regarded as "special" or whether "universal banking" prevails.

That, of course, is far too big an agenda for a single paper. In his paper, Todd carefully focuses on one small, but vitally important element in this structure—the legal framework for supervising and

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regulating financial services firms in the United States.¹ Todd discusses supervisors' preclosure enforcement activities, but pays particular attention to the criteria for closing failed banks and the changes that were made in them by the Competitive Equality Banking Act (CEBA) of 1987, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, and the FDIC Improvement Act (FDICIA) of 1991. This comment picks up the enforcement theme, presents and analyzes some new interagency data on enforcement actions, and draws attention to the lack of criteria for evaluating enforcement activity.

Tinkering With The U.S. Financial System

It is interesting to ask why the United States has not achieved a greater degree of financial reform than it has. Early in the 1980s, the administration was set on a path toward expanding bank and thrift powers (that culminated in the Senate's repeal of the Glass Steagall Act in 1988) and deregulating the financial service industries. The Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 and the Garn-St Germain Act of 1982 took steps in that direction (Cargill and Garcia 1982, 1985).

At the latest count, however, Congress and the administration have tightened control over the banking and thrift industries and limited their powers to those permissible for national banks. Why did this happen at a time when Western European countries and Japan were liberalizing their financial systems?

Part of the answer, I believe, lies in the success, until the 1980s, of the system set in place in the United States during the Great Depression. Deposit insurance was credited with stabilizing the financial system and aiding the economy; so, other countries began to adopt similar systems. The very success of the U.S. system caused many analysts to overlook the fundamental agency problem inherent in the system of deposit insurance. The large number of bank and thrift failures revealed this flaw and modern finance theory has analyzed it. Deposit guarantees allowed owners of publicly owned banks and thrifts to incur more risk than debt-holders would have permitted if they had not been insured by the government.² This problem blossomed into full scale moral hazard and adverse selection when inflation and consequent high interest rates virtually bankrupted the thrift industry

¹Other people in this conference and elsewhere have dealt with other aspects of this broad topic.

²Conversions from mutual to stock charters were common for savings banks and S&Ls in the 1980s.

at the beginning of the 80s. Weak and bankrupt thrifts gambled at taxpayer expense. Taxpayers lost \$200 billion plus interest. And today weak banks can gamble in the derivative products market.

Ignoring these fundamental problems led the United States to apply a marginal approach to financial reform.³ More fundamental changes that would have allowed interstate branching, the repeal of the Glass-Steagall Act, unified banking and commerce, as contained in the administration's version of FDICIA, for example, were defeated. The U.S. political system almost requires consensus for legislation to be enacted (Garcia 1993).⁴ There was no chance of building consensus on financial modernization when critics characterized these reforms as reckless social experiments at a time when the most important objective was to bring moral hazard in the deposit insurance system under control. Instead of restructuring the financial system, banks' capital requirements were raised, the powers of state-chartered banks and thrifts were limited to those of national banks, early intervention and prompt closure were legislated, supervision increased, and enforcement tightened, in order to protect the deposit insurance funds and the taxpayer from further losses.

In this comment, I will focus on the tightening in enforcement and raise issues associated with congressional supervision of the regulatory agencies' enforcement actions.

Oversight in the Banking and Securities Industries

During the 1980s, Congress became increasingly impatient with the performance of the bank and thrift regulatory agencies. In the United States, direct financing through the securities markets is governed by a caveat emptor philosophy. The role of the Securities and Exchange Commission (SEC) is to make sure that participants in the securities markets have sufficient information to protect their own interests.

The philosophy underlying bank regulation has been different. Most depositors are assumed to be too small, unsophisticated, or busy

³In the 1980 and 1982 Acts, to give just three examples: Regulation Q was removed to end cyclical disintermediation, reserve requirements were extended to all depository institutions to help the Federal Reserve control the money supply, and S&Ls were allowed to invest in a wider range of products to reduce their reliance on fixed rate mortgages.

⁴Recognition of a crisis and agreement on a solution were necessary to enact financial legislation under a Republican administration and Democratic Congress (1987-92). President Clinton is currently trying to force legislation through Congress without Republican support, but it is not clear that he can do so.

elsewhere to spend time and money evaluating the soundness of their bank, thrift, and/or credit union. It has been the regulators' job to ensure the safety of funds deposited in these institutions, by examining the safety and soundness of bank operations and guaranteeing domestic deposits up to \$100,000.

For many years, the bank and thrift regulators in the United States maintained a high degree of secrecy over the condition and performance of the institutions they oversaw. Regulators argued (and sometimes still argue) that releasing information about a weak institution could lead to a run, while publishing information about a sound bank or thrift would reveal confidential information to its competitors. The regulatory stance to the public was, "We will guarantee the safety of this institution, so you do not need to worry about it." This was particularly true for large institutions, such as Continental Illinois, Bank of America, and Citicorp which were nursed until they recovered rather than being closed (Fromson and Knight 1993).

There was a degree of ambivalence about releasing data, especially data on individual institutions, to congressional members and staff. While acknowledging that Congress might need some data in order to exercise its legitimate oversight responsibilities, regulators feared that the data could be misused and lead to a crisis. When data were supplied in response to a request, a condition was typically imposed that information be kept confidential. The regulators' advice to Congress can be summed up colloquially, "Leave it to us, we will take care of it."

The 1980s can be viewed as a period when Congress accepted this assertion, deferred to the regulators, trusted that they, together with increased market discipline, could resolve the problems that existed (particularly the thrift problem) if given enough time. The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Act of 1982 reflect this trust (Cargill and Garcia 1982, 1985). The regulators had advised that giving thrifts (and, to a lesser degree, banks) greater powers and themselves greater authority could resolve the problems that existed.

By the end of the 1980s, however, Congress had decided that its trust had been misplaced. Hearings held by the Senate Banking Committee in the Spring and Summer of 1988 (U.S. Congress 1988a; 1988b), for example, dispelled that confidence and started Congress and the administration on the long road toward resolving the thrift debacle and the deposit insurance crisis in the FIRREA of August 1989, and FDICIA of December 1991. Congress had also come to doubt the energy and enthusiasm of the Justice Department in pursuing litigation against S&L crooks that the regulators referred to it.

Title IX of FIRREA

Title IX of FIRREA, which deals with Regulatory Enforcement Authority and Criminal Enhancements, expressed Congress' dissatisfaction with the regulators' use of their disciplinary powers and with the seriousness of the Justice Department's pursuit of S&L criminals. Title IX extended bank-equivalent enforcement powers to the thrift oversight agencies; clarified powers to issue cease and desist (C&D) orders; increased the grounds for and maximum value of civil money penalties (CMPs) that regulators could impose on wrongdoers in the industry; made supervisory records maintained by other regulators available to the FDIC; broadened the prohibition against the employment of persons convicted of dishonesty or a breach of trust in banks and thrifts; and provided for the publication of formal enforcement actions and more data on agency activities.

Section 918 of FIRREA mandates that the federal banking agencies and the Attorney General report annually to Congress on their enforcement activities. The conference report for the Act requires the agencies to provide data on: "informal and formal supervisory, administrative and civil enforcement action(s) initiated and completed in any year and the number and value of civil money penalties" (CMPs); "break down data on investigations, prosecutions, and convictions"; comment on "any concerns about the Justice Department's handling of these matters, including inadequate responses, unnecessary delays, or other problems"; and recommend additional legislation where needed (U.S. Congress 1989: 323). Unfortunately, neither the legislation or the conference report provide guidance on what the enforcement provisions sought to achieve beyond punishing the crooks in the S&L industry. Consequently, it is unclear how to evaluate the contents of the annual reports that Section 918 mandates.

The agencies' reports record the number of formal and informal actions taken each year; the amount of civil money penalties assessed and still outstanding from individuals and institutions; and other enforcement activity. The content and style of the agencies' annual reports differ somewhat. The FDIC names the individuals and institutions punished or involved in enforcement litigation and summarizes progress on each case; the Office of the Comptroller of the Currency (OCC) and the National Credit Union Association (NCUA) do not. The Federal Reserve (FR) names the individuals and institutions against which it assessed civil money penalties. The Office of Thrift Supervision (OTS) provides a summary of cases settled and outstanding against (named) institutions and individuals.

The resulting Section 918 reports prepared by the agencies ultimately reach the desks of congressional staff responsible for overseeing

the regulatory agencies for use in the annual oversight hearings on the banking, thrift, and credit union industries and their regulators. But how should Congress evaluate these reports?

Has FIRREA Increased Enforcement Activity?

Improving enforcement was an important objective in FIRREA; Title IX is devoted to it. It is possible to discern that enforcement activity has increased since the Act.⁵ For example, Table 1 shows available data on the number of formal and informal enforcement actions initiated by the OCC, FDIC, FR, OTS, and NCUA in the years before and after FIRREA. It is, however, more difficult to determine whether regulatory supervision has improved. Is more, better?

For the OCC, formal actions increased in 1990, 1991, and 1992 from low levels in 1988 and 1989.⁶ Nevertheless, despite these increases, OCC took fewer formal actions in 1992 than in 1985. The number of informal actions rose sharply (eightfold) between 1990 and 1992. At the FDIC, formal actions rose in the two years following FIRREA, but there was no discernable pattern to informal actions, which peaked in 1988, before the Act was passed. The Federal Reserve's formal actions increased in 1990 and 1991. It is not possible to compare OTS's post- and pre-FIRREA behavior, because OTS's records start in 1990 and the agency says it does not have access to its predecessor's (the Federal Home Loan Bank Board's) records. NCUA's data show that the number of its actions increased eightfold between 1989 and 1990 and have continued to rise since then.

Comparing the Agencies' Enforcement Activities

Table 1 shows that OTS took the greatest number of formal and informal actions in 1990 and 1991.⁷ (Data for 1992 from the FDIC and OTS are not available when the paper was written.) NCUA took the lowest number of formal enforcement activities in these two years.

The number of institutions supervised and the value of their assets varies considerably among agencies. Table 2, therefore, examines the

⁵In addition to the legislation, increased enforcement activity may have resulted from changed macroeconomic conditions that weakened financial institutions and/or an easing of budget constraints on the supervisory agencies.

⁶Enforcement activity at OCC may have increased in response to the criticism that Robert Clarke received in the Senate Banking Committee's hearings to consider his nomination for a second term as Comptroller of the Currency (U.S. Congress, 1991).

⁷A press release by OTS says that "the agency's enforcement efforts have peaked and will decline now that we have worked through the bulk of cases tied to the thrift crisis."

TABLE 1
ENFORCEMENT ACTIONS INITIATED, 1984-92

Year	OCC ^a		FDIC ^b		FR ^c		OTS ^d		NCUA ^e	
	Formal	Informal	Formal	Informal	Formal	Informal	Formal	Informal	Formal	Informal ^f
1984	457	41	218	n.a.	129 ^g	n.a.	n.a.	n.a.	4	n.a.
1985	607	20	353	n.a.	214 ^g	n.a.	n.a.	n.a.	1	n.a.
1986	329	62	228 ^h	455 ⁱ	339 ^g	n.a.	n.a.	n.a.	6	n.a.
1987	296	232	236	413 ⁱ	166 ^g	n.a.	n.a.	n.a.	0	n.a.
1988	204	127	223	731	155 ^g	n.a.	n.a.	n.a.	2	n.a.
1989	275	140	228	670	150 ^g	n.a.	n.a.	n.a.	4	n.a.
1990	412	147	255	579	176	298	536	3,129	33	655
1991	488	1,006	356	655	245	297	1,063	1,561	43	462
1992	563	1,221	n.a.	n.a.	295	365	n.a.	n.a.	52	276

^aOCC *Quarterly Journal*, Vol. 9, No. 1, and OCC's *Annual Reports on Enforcement* for 1991 and 1992.

^bFDIC's *Section 918 Report to Congress* for 1991; *FDIC Annual Report* for 1988.

^cBoard of Governors of the Federal Reserve System *Staff Report to Congress* for 1990 and 1991.

^dOTS Enforcement Actions and Initiatives; *Annual Reports to Congress*. Includes civil money penalties which OTS reports separately.

^eNCUA's *Annual Reports* for 1984-90, and *Section 918 Reports to Congress* for 1990-92.

^fInformal actions are actions finalized in 1991 as data on actions initiated are not available.

^gFederal Reserve data from internal agency *Annual Reports on Formal Enforcement Actions* for each year.

^hData courtesy of Mike DeLoose, FDIC Legislative Advisor, Office of Legislative Affairs.

ⁱData for memoranda of understanding only.

	OCC ^b	FDIC ^b	FR ^b	OTS ^b	NCUA
<i>Formal Actions</i>					
per 100 institutions	12.5	4.6	24.9	48.0	0.3 ^b
per \$100 billion in assets	24.9	33.7	42.8	115.4	23.0 ^b
<i>Informal Actions</i>					
per 100 institutions	25.8	8.5	30.2	70.4	3.6 ^c
per \$100 billion in assets	51.3	61.9	51.8	169.5	247.1 ^c
<i>All Actions</i>					
per 100 institutions	38.3	13.1	55.1	118.4	3.9 ^d
per \$100 billion in assets	76.2	95.6	94.6	284.9	270.1 ^d

^aNumber of institutions and their assets are for June 30, 1991.

^bActions initiated in 1991.

^cActions finalized in 1991, as data on actions initiated are not available.

^dFormal actions initiated plus informal actions finalized.

SOURCES: Data on enforcement actions came from each agency's annual *918 Reports to Congress* (see Table 1). Data on the number of institutions supervised and their assets were obtained from the Congressional Relations Offices of the OCC, FDIC, FR, and NCUA. Data for OTS came from its *Selected Indicators for all Private Sector Thrifts* 1991.

number of actions taken; (a) per 100 institutions supervised, and (b) per \$100 billion of assets supervised. OTS has relatively the highest number of formal actions. NCUA had the lowest number of formal and informal actions per 100 institutions supervised, but the highest number of informal actions per \$100 million of assets supervised.⁸

Table 3 reports the different types of formal and informal actions taken by the different agencies in 1991. There is some overlap; all agencies issue C&D and removal/prohibition orders and assess civil money penalties. Otherwise there is a surprising variability in the types and/or the names of actions taken by the different agencies. NCUA relied almost completely on informal actions while the Federal Reserve split its activities more equally between formal and informal actions.

This variability illustrates just one of the difficulties faced by the Administration and the chairmen of the House and Senate Banking Committees in their current efforts to rationalize and consolidate the bank and thrift regulatory agencies. Someone, for example, will have to decide whether all of these different enforcement actions are necessary and, if not, which should be continued and which curtailed.

Has Enforcement Improved Since FIRREA?

One can conclude that enforcement activity has increased at all of the bank regulatory agencies since FIRREA. But more activity does not necessarily mean more successful enforcement activity. It is not clear from the legislation or its history how to measure success.

Success depends on what Congress intended, beyond punishing the known criminals and deterring others, by tightening enforcement. Although not clear from the legislation, that additional intent could be of two kinds. The first would lead to prompt closure and less costly resolution, an avenue that Todd pursues in his paper, but it might also involve corrective enforcement actions that lead to recovery, rather than demise. It is in assessing recoveries that the measurement difficulties arise.

Section 918 requires agencies to report the number of actions initiated in any year and the number completed. But completing an action does not necessarily mean that it has been successful. The section also requires that agencies report the value of civil money penalties (CMPs) assessed and the amounts that remain uncollected. The value of CMPs collected is one measure of success, but it is not a comprehensive or completely satisfying one.

⁸NCUA, for example supervised the most institutions (12,653) with only the smallest of the agencies value of total assets (\$261 billion) at the end of 1992.

TABLE 3
TYPES OF ENFORCEMENT ACTIONS INITIATED, 1991

	OCC	FDIC	FR	OTS	NCUA
<i>Formal Actions</i>					
Application Conditions	13				
Capital Directives	1	2	2	95	
Cease and Desist Orders*	85	158	53	255	12
Civil Money Penalty Orders	190	11	51	199	21
Conservatorships/Receiverships	0			338	0
Formal Agreements	148		76		
Removal/Prohibition Orders	41	74	46	157	10
Suspensions	3		2	3	0
Trust Power Revocation	0				
Termination of Insurance		81			
Injunctive Actions		25		6	
Part 513 Actions				10	
Orders of Investigation	7	5	15		
Total Formal Actions	488	356	245	1,063	43
Formal Actions as a Percentage of all Actions	32.7	35.2	45.2	40.5	8.5

<i>Informal Actions</i>					
Board Resolutions	93	223		28	
Capital Plans				150	
Commitment Letters	205			0	
Consent Merger Agreements				82	
Formal Investigations				93	
Letters of Reprimand	152				
Memoranda of Understanding	37	432		28	
Letters of Understanding					462 ^b
Supervisory Agreements				325	
Supervisory Letters	519				
Supervisory Directives		821			
Requests for Voluntary Management Changes				34	
Total Informal Actions	1,006	655	297	1,561	462^b
Informal Actions as a Percentage of all Actions	67.3	64.8	54.8	59	91.5
Total Actions	1,494	1,011	542	2,624	505

^aIncludes temporary and permanent cease and desist orders.

^bData for letters of understanding represent final actions as information on actions initiated are not available.

SOURCES: Data from agency *Section 918 Reports*.

Civil Money Penalties

The Federal Reserve's 918 Report for 1991 states that, between 1975 and 1990, respondents had defaulted on \$4.1 million of the civil money penalties it had assessed. Congress perceived the agencies' collection problems as a lack of dedicated follow-through so that Section 918 requires the agencies to report the number and amount of civil money penalties assessed and the amount not collected. It is now possible to evaluate the success of CMP activity according to the ratio of the value of CMPs collected to those assessed.

There has been a marked improvement since 1990 in the ratio of assessments collected at the Federal Reserve. In 1990, less than one percent of the fines levied were paid. In 1991 and 1992, fewer fines were levied, but all were paid in 1991 and virtually all in 1992. OTS appears to have been consistently successful in collecting virtually all of the fines it levied in 1990 and 1991. OCC has collected roughly half of what it assessed in the past three years. FDIC data show a low and variable success rate. These data leave questions. Is it useful to levy CMPs without collecting them? Is it better to levy fewer fines, but collect more of them?

Evaluation Criteria

The questions regarding civil money penalties emphasize that the criteria for evaluating the broader range of supervisory actions are largely undeveloped. The congressional task of assessing whether the regulatory agencies are carrying out their enforcement activities successfully remains an unscientific one. There appears to have been little attention in academic circles to this subject.

A methodological advance is needed. How otherwise will one be able to assess whether, for example, FDICIA's prompt corrective action (PCA) provisions are being faithfully carried out by the different bank and thrift agencies? How will one assess whether PCA is proving successful in achieving Congress's intentions to impede forbearance for troubled institutions and reduce the risk of loss to taxpayers? Some financial regulators, resenting PCA's reduction of their supervisory discretion, could issue regulations in such persnickety abundance as to call the legislation into disrepute.⁹

How then can Congress conduct worthwhile oversight of the regulatory agencies in the post-FIRREA and post-FDICIA environment? A final reality check can be made by examining the numbers of

⁹For example, the American Bankers' Association and others have argued that FDICIA has overregulated the banking industry and contributed to the credit crunch.

institutions that fail and the cost of their resolution. But it would be better to have some measure of success at an earlier stage of the supervisory process. A comparison among the agencies of the percentage of institutions in the different capital bands (ranging from well-capitalized to undercapitalized institutions) would give some indication of relative performance. Some law firms in Washington keep a tally of the regulations which FIRREA and FDICIA require the regulators to promulgate and the progress that the regulators have in complying with its requirements. But such an approach is mechanistic and overlooks the possibility of regulatory overkill.

More sophisticated tools of oversight are needed. For example, supervisors might be required to reveal their objective for taking a particular action, such as, issuing a cease and desist order, making a capital directive or imposing a suspension. After a predetermined interval, they should evaluate whether each action has achieved its objective. This information should be subject to Congressional oversight. But creative readers may be able to construct additional measures of supervisory success.

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